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CURRENCIES AND CREDIT MARKETS

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"During 1932, bank loans were being liquidated and bank deposits were going down. But total bank reserves were increasing and excess reserves were substantial. Federal Reserve authorities felt that their monetary policy had made credit expansion possible . . . what the country was struggling with appeared to be, not a shortage of money, but a shrinkage of values."

American Monetary Policy, E. A. Goldenweiser, 1951
Late Chief Economist at the Washington Federal Reserve.

HIGHLIGHTS

Wall Street has sold the delusion that the present recession is just a normal postwar variety and moreover, that it will be unusually short and shallow. We must insist otherwise. We again outline our reasons explaining why it's a more serious financial recession and not a monetary-induced one.

Past credit crunches were solely caused by tight money could always be easily turned off again by loosening policy. What, however, can the Fed do against a credit crumble that has occurred despite an aggressive monetary easing, much the less the cause of a tightening?

The downturn in U.S. commercial real estate is far from over and is at the heart of the U.S. debt deflation. A gross oversupply of property interacting with the associated banking and credit crisis will keep value and capital destruction and debt-deflation in force for many more years.

Government efforts to bail-out the S&L's and troubled banks only benefits the depositors while actually undermining the financial system. We explain why. In short, what we see unfolding is a prolonged credit crumble.

We show that banks, corporations and consumers have entered the current recession in the worst financial condition since the Great Depression. How anyone could postulate an economic recovery under these horrendous conditions is beyond us.

We compare the financial and economic structures of the United States, Japan, and Germany. One's down for the count, one's maimed financially and one's strong but slowing. The risk of global financial and economic instability is high.

Money growth in Japan, as in the U.S., has also collapsed to unprecedented lows. What we see in both countries is that capital availability has become more important for bank lending and money growth than excess reserves. Potentially, that defeats the effects of any monetary easing.

We see little prospect of any monetary easing in Germany for many months.

For 1992, consensus still envisions a world economic recovery led by America. In our view, rather than focusing on the relative strengths and growth rates, it's time to start pondering weaknesses and the relative vulnerabilities to a world recession.

APPROACHING THE WATERSHED

On October 15th and 16th, the international media reported three corporate events that seemed to be of some fundamental importance:

- Westinghouse Electric Corporation's beleaguered financial unit announced that it is tapping $1.5 billion in bank credit because of investor reluctance to buy its short-term paper. The move comes as the company restructures its credit lines to boost borrowing by as much as $2 to $8 billion.

- Citicorp, beset by souring loans and investments, surprised Wall Street by booking a $885 million loss in the third quarter. The bank also announced that it was halting dividend payments on its common shares for the first time in its 179-year history.

- "Big blue", IBM, didn't escape an earnings squeeze either. It reported earnings of 30 cents per share for the third quarter, down markedly from $1.95 a year earlier. The company now expects to cut its work force this year by 20,000 world-wide. The stock went up sharply on the news. It made sense to a certain pundit who was quoted as saying: *"That's consistent with the perception that we are in an earnings bottom and the recovery is around the corner."*

The obvious hard times befalling these corporate titans fell on deaf ears. Do you remember what Wall Street did that week? Stock prices catapulted to record highs.

WALL STREET'S NEWSPEAK

Newspeak, for those who don't know, was the official language of Oceania in George Orwell's famous science-fiction novel, 1984. It was a language made up of terminology that was designed to diminish the range of thought. That was done chiefly by eliminating undesirable words and by stripping such words as remained of their old meanings. Newspeak, therefore, was a main tool in applying the Party's key slogan: "Ignorance is strength."

Just like the government of Oceania, Wall Street has also successfully eliminated the non-constructive thoughts associated with undesirable words — words like crisis, unemployment, or profit squeeze. In Wall Street's "newspeak" and "newthink", anything with negative connotations is re-inflected as something highly positive.

We may be stretching the analogy to Orwell's book, yet, consider some examples of modern-day "newspeak." Since time immemorial, the mass firing of people was regarded as a sign of corporate bad management and distress. Presently, one North American blue-chip company after the another is doing just that by the tens of thousands of employees. But Wall Street's "newspeak" has given this depressive reality of job losses — not just lay-offs, but job losses — a new sheen with such proactive and inspiring slogans as "restructuring" and "downsizing." Instead of criticism, what's evoked is the championing of hard-nosed, super-efficient managements in pursuit of higher profits. Catering to this "newthink" with corporate bravado, firms now eagerly flaunt such plans though they may be coupled with huge write-downs. And, correspondingly, Wall Street rewards them with sharply higher share prices.

ANOTHER MISLEADING MYTH: THE PERFECT MARKETS

That brings us to a few more of Wall Street's joyous "newthink" slogans: "*markets are perfectly rational and efficient*"; that "*markets anticipate*"; and that "*market prices reflect all available information.*" From these three axioms follows the blissful conclusion that any economic or financial woe, no matter how bad,

if they are known by the markets they are "yesterday's problems" and simply not important. This means that such potential time bombs as the rising budget deficit, the thrift and banking crisis, the real estate crisis . . .etc. do not count any more because the markets have already "discounted" them and fully identified and anticipated their impact on financial markets, past, present and future.

It's hard to believe that such nonsense has so many card-carrying disciples. Unfortunately, these "known" negatives that Wall Street prefers to assume away continue to debilitate the economy today at a progressing rate. In reality, these slogans suppress commonsense and instead, rationalize perfect blindness.

Take the latest hot topic — the collapse in the money supply. We have a question. How can the financial markets sufficiently discount the present monetary contraction when most of the experts are at a complete loss to explain it? If the "consensus" diagnosis of the problem is incorrect, the market's "discounting" of it is also liable to be incorrect.

After having long ignored the monetary sluggishness, economists everywhere — in banks, brokerage houses, government and the media — are literally falling all over themselves trying to explain away what has caught them by complete surprise. With surprising conformity, they all advance the exact same soothing conclusion: Don't worry. The claim is made that financial deregulation has broken the historical linkage between money and GNP; consequently, faster monetary growth is no longer a precondition for recovery. And, the unusual credit weakness doesn't elicit any worries either, the argument being that it "is fully in line with past recessions."

Clearly, this sweeping conversion to radical anti-monetarism must be of a very recent vintage. Less than a half year ago, both economists and financial markets were agog at the sight of a sudden spurt in the various monetary aggregates. For a two to three month period, they climbed at rates between 8 to 11%. Then, apparently, everyone was still an avowed monetarist. With little hesitation, the monetary up-tick was immediately hailed as an early, infallible sign of recovery, and as proof that the banking crisis did not at all impair money growth and recovery prospects.

ONCE AGAIN, SLUGGISH MONEY GROWTH REVIEWED

In past letters, we have written a lot about the interrelationship of money and credit and its causal role in the present U.S. recession. We briefly return to this topic again since it is an issue of uttermost importance. In recent weeks, a lot of additional information has become available — both nationally and internationally — that has greatly sharpened our view and afforded more precise insights.

And, in the meanwhile we have also greatly benefitted from a study entitled Bank Credit Crumble, published by the Federal Reserve Bank of New York. Given its content, we wonder why the media hasn't given it any attention. We haven't seen mention of it anywhere.

EVERYTHING IS DIFFERENT THIS TIME

Wall Street so far has successfully sold the delusion that this recession is just a normal postwar variety and, moreover, that it will be unusually short and shallow.

We must insist otherwise. This recession is fundamentally different from any previous postwar recession. It's entirely different in its causes, in its effects, and it will be different in its depth and length. A number of key symptoms point to a completely different set of deeper-lying causes. To review, the main

distinguishing symptoms are listed as follows:

- All past recessions were preceded by a credit crunch that was implemented by tightened bank reserves and rising interest rates. Since these recessions were mainly brought on by tightening monetary conditions they were therefore easily reversible by simply loosening the monetary screws.

- In 1990, neither of the traditional causes of a credit crunch were in evidence. Instead, well before the onset of a recession bank reserves were ample and the Fed was slashing short-term interest rates. Yet, all the same, the economy slid into recession.

- During past recessions, falling credit demand mainly reflected a rapid and massive inventory liquidation. This time, falling credit demand is more closely associated with weakening consumption and investment, collapsing collateral values and large loan write-offs.

- It's a common occurrence during recessions that private credit expansion declines sharply. What's different this time, apart from the main cause, is that it has fallen to a growth rate of 2.4%, the lowest in over 40 years. Taking inflation and interest costs into account, this implies that a drastic credit contraction is unfurling. In the meantime, government debt grows at a record pace.

- For the first time ever, the prospect of stimulative fiscal policy is forestalled by gargantuan budget deficits. As it is, presently-high deficits are already non-stimulative due to runaway interest costs and the S&L bailout. Instead of taxes being reduced, taxes are being raised.

The above features clearly show that this recession has a completely different footprint from past postwar recessions.

A CREDIT "CRUMBLE"

There is little discussion centring on the above distinctions. Instead, all of these big negatives have been ignored or explained away. Why? Purely and simply, because an alternative explanation would mean the scrapping of any bullish forecast for the U.S. economy and the stock market.

The contortions of logic employed to support these complacent forecasts are simply breathtaking to us. A recent comment by Business Week was symptomatic of the mood, when it triumphantly stated: "*This time the economy was brought down by the financial excesses of the 1980s, not by tight money. Those excesses produced a commercial real estate glut, a shaky banking system, and a bankrupt thrift industry. So the fall in M2 is a phoney sign of impending disaster.*" In other words, since it isn't the cause of a tight monetary policy, don't worry about the weak money supply. It only stems from the triad crises of real estate, banking and thrifts, and therefore doesn't matter.

Our own logic runs exactly the opposite. Past credit crunches which were caused solely by tight money could always easily be turned off again by loosening policy. What, however, can the Fed do against a credit crunch that has occurred despite aggressive monetary easing, much the less because of a tightening?

Any attempt to answer that question has to start with a thorough analysis of the specific causes of this unprecedented credit crunch. Just that kind of analysis has been sadly avoided by most economists. The first attempt of this kind, based on internal information unavailable to the outsider observer, was the already-mentioned article, Bank Credit Crumble, in the New York Fed's recent Quarterly Review. Its conclusions

flatly fly in the face of the populist "don't worry" articles.

Fundamentally, the article states that both a cutback in the supply of loans and falling loan demand have contributed importantly to the credit compression and the resulting economic slump. As the chief cause of the diminishing supply, the article pinpoints a "*a deflation in asset prices*" or "*a broad-based shortage of bank capital.*" The author calls it a "*credit crumble*" in order to differentiate the present credit tightness from the traditional "credit crunch" caused by tight money.

MEASURING THE COLLATERAL PROBLEM

The most crucial question at this point is whether those forces constricting the credit supply to the private sector are either easing or worsening? Answering this question we first need to have an idea of the size of the banks' loan problems relative to their capital base.

Including the branches of foreign banks, U.S. commercial banks presently dispose $228 billion of equity capital. Against this they have three main categories of particulary risky loans on their books: commercial real estate of about $400 billion; highly leveraged transaction loans (HLT's) to corporations of about $190 billion; and lastly, loans to developing countries amounting to approximately $60 billion. At the same time, defaults on the historically safe categories of home mortgage loans and consumer loans are running at new highs totalling another $450 billion and $385 billion respectively. That makes for a total of almost $1.5 trillion in questionable loans, more than six times the equity base.

Again a little history may be in order. In the last letter we showed that the stock market speculation in the 1980s (not to mention the present bout) was far more reckless than that of the 1920s. The same comparison applies to the commercial banks. In 1929-30, when the stock market dived, the banks and other lenders suffered no losses in the liquidation of stock market credits since they had plenty of margin on their collateral.

Bankers then still knew and respected the difference between a bill of exchange and a mortgage. Mortgage loans were generally looked at askance by the larger American banks while second mortgages were considered downright improper in a bank's loan portfolio. The one larger bank that crashed during the 1929-33 period, the Bank of the United States, was the great exception to these principles and had gone heavily into illiquid mortgages.

Today, most American banks are running over with illiquid loans on their books. Not only that, all financial institutions (including banks, thrifts, insurance companies and pension funds) accepted wafer-thin safety margins on these high-risk illiquid loans for the sake of big front-loaded fees. In 1989, nearly half of banks' profits came from the fat margins earned on commercial real estate loans and HLT's.

What was it that drove American and other bankers into these reckless loan policies? Two things figured prominently: firstly, tough competition; and secondly, the assumption that a single bank can at will "create" the deposits it needs through the national and international money markets . . . that is through brokered deposits and bank-to-bank loans. Seizing on this apparently unlimited source of deposit creation, many bankers no longer saw any constraint to their ability to extend illiquid loans. In many countries — mainly the Anglo-Saxon countries and most of the Scandinavian ones — sound banking practices went the way of the dodo during the 1980s.

FISHER'S DEBT-DEFLATION PROCESS

Back to our earlier question: Are the credit and monetary troubles "yesterday's problems?" For reasons we will explain, we think it's virtually inevitable that the carnage in real estate will gather force. It follows that the adversities for the financial system and the economy must also be gathering force.

What we see here is the famous process of self-perpetuating deflation as described by Irving Fisher in his 1933 article The Debt-Deflation Theory of the Great Depression. His crucial point was that the very effort of corporations and individuals to lessen their burden of debt by borrowing and spending less, has in reality exactly the opposite effect in the aggregate by spreading illiquidity further. It is, he concluded, the chief secret of most if not all, great depressions.

He describes in detail how this process of self-deflation works: More and more forced sales of assets — mainly real estate — cause a massive destruction in values and wealth. These losses are not confined to the direct owners and financiers of over-leveraged and uneconomic buildings since property prices and rents sink across the board. As a result, debt-to-collateral and debt-to-income ratios soar across the whole real estate market endangering ever more and more property owners.

Over time, this process of value destruction is reinforced by a corresponding process of income and cash-flow destruction through lease roll-overs. As existing leases expire, the tenants extricate rent cuts from landlords or, if not, move to new buildings that are under greater motivation to offer cheaper rents. Virtually every new lease spreads the value-destruction process from the "bad" buildings to the "good" buildings. Even though the growth of debt may be drastically reduced, debt loads nevertheless increase because underlying incomes, cash flows and asset prices shrink.

Based on this analysis, the downturn in commercial real estate isn't even near over. The gross oversupply of property interacting with the associated banking and credit crisis will keep the value destruction and debt-deflation in force for many more years.

QUARANTINING THE DEBT DEFLATION?

Many economists have pooh-poohed the contraction in bank lending as being nothing to be concerned about employing the argument that there are sufficient alternative non-bank sources for credit, such as commercial paper, life insurance, pension funds . . . etc. That was true for some time, but, no longer.

The credit "crumble" disease is essentially contagious. The credit contraction is spreading from one financial sector to another. First it was the S&L's, then the banks, then the insurance and finance companies and then commercial paper. The latter credits were liquidated at an annual rate of $116 billion in the second quarter of this year. Simultaneously, the life and health insurance industry suffered a massive run on its assets. A record-high demand for policy loans has forced them to sell off liquid assets. For the first time on record, life insurance companies have virtually ceased making commercial real estate loans. And, one cannot forget the S&L's which are still contracting an annual rate of about $160 billion.

A BAILOUT THAT FAILS TO BAILOUT

There is a complacent notion that the S&L and bank failures don't matter, unlike the 1930s, because government can cover the problem. That's another great delusion. The government takes care of the depositors alright but leaves all the other problems unaddressed. Chiefly, these are of three kinds: deposit

destruction, reserve destruction, and asset value and capital destruction.

The depositors are the only party that don't lose anything. The financial system as a whole, though, suffers a corresponding money and liquidity contraction due to the fact that the government is financing these payouts. The sale of Resolution Trust Corporation (RTC) debt (mainly employed to replace destroyed deposits) tends to absorb existing deposits which in turn reduces reserve demand. And, since the Federal Reserve is targeting the fed funds rate, it mops up the surplus reserves. The net effect is less money supply and more government bonds. In short, the RTC bailout amounts to contractionary open market operations.

Even more damaging is still another effect on the financial system — the shrinkage of asset and collateral values. While the depositors get new deposits, the S&L's or banks and their defaulting debtors don't get new assets. The whopping asset value and capital destruction continues unhampered impairing the system's ability to create loans. In short, the bailout is no bailout for the system, only for the depositors. Indeed, it is compounding the problem. Admittedly, the Resolution Trust Corporation has quarantined some of the asset deflation problem by keeping about $300 billion of real estate assets off the market. Undoubtedly, that has forestalled a panicky price collapse.

Preventing shock effects and postponing liquidation, though, doesn't solve the problem. The knowledge that there is a large and growing overhang of assets yet to be liquidated is apt to depress markets in the long run, resulting in a permanently crippled banking system and real estate market. In short, what would transpire is a prolonged credit crumble instead of quick credit crash.

THE SELF-DEFLATING CONSUMER

Recessions are periods in which banks and borrowers reliquefy their balance sheets. This reliquefication, in fact, is one of the indispensable pre-conditions for the following recovery. The key question, then, is this: Are consumers and corporations improving their liquidity? Not at all. To us it appears that both are becoming increasingly illiquid.

Take the consumer. Spending has increased 4% year-over-year; meanwhile income has grown only 3.2% — the lowest gain in 35 years. Many tapped their savings to pay bills. Some consumer credit has been repaid — for example auto loans — but recently, mortgage borrowing has again been stepped up. True, the consumer has slowed his debt growth drastically — down to a rate of 4.6%, during the first half of this year taken annually. That compares with 11% growth in 1988, 8.9% in 1989 and 4.9% in 1991. The problem is that income growth is falling even faster. Therefore, the consumer is becoming increasingly illiquid.

Significantly, at the same time income is lagging the consumer's wealth is crumbling. The latter is mainly due to a weak housing market. Throughout the whole postwar period, ever-rising home prices have supported the enormous rise in consumer debt. Now, for the first time in the postwar period, consumer net worth (assets minus liabilities) is melting.

A CORPORATE CASH SQUEEZE

And what about corporate liquidity? During recessions, corporations have usually been able to reliquefy their balance sheets through two channels: internally, by liquidating mainly inventories; and externally, by boosting new bond and stock issues. In so doing, by the time an economic recovery began, corporations had large liquidity cushions. The same processes are again at work, yet businesses are not reliquefying. Why?

The first reason is that inventories had already been lean well before the recession and therefore allowed only marginal room for further inventory liquidation. Another reason is the advent of an internal cash flow squeeze. Cash flows taken at an annual rate has fallen from $403 billion in 1988 to $337 billion recently. The main reasons for that squeeze is a sharp slowdown in depreciation charges and, most of all, the literal disappearance of undistributed profits.

Corporations have been paying more and more dividends out of less and less profits. Since 1988, dividend payments rose from a level of $80 billion annually to $115 billion in 1990. Pre-tax profit levels, on the other hand, have fallen from $251 billion to barely $200 billion.

One avenue of reliquefication that's functioning normally is the issuance of corporate bonds. New bond issues are running at the highest level in years. What's new is that corporations are using the proceeds almost entirely to repay short-term debt. As a result, measured by their net inflow of funds, businesses are retrenching as never before.

Reviewing all these trends, the evidence clearly indicates that banks, corporations and consumers have entered the current recession in the worst financial condition since the Great Depression. How the experts can continue to postulate a sustainable economic recovery under these horrendous conditions is beyond us. There isn't a sector to be found anywhere that has the financial strength to help finance a recovery.

FINANCIAL AND FUNDAMENTAL DISSONANCE

If the financial situation is really so bad, how can the securities markets be celebrating with such bullish vigour? While the real estate market is starving of liquidity, securities market are floating in it. Stock price inflation coexists alongside savage real estate deflation. How is that possible? Many people are convinced that the durable bull run in stock prices is the surer sign of prosperity and confidence and that the disastrous real estate markets and financial structures are extraneous anomalies.

To be sure, this gross dichotomy between the two asset markets cannot coexist forever. The financial decoupling, though, can continue for a while. One reason why is that the stock market, barring a large new issue calendar, can flourish on a very small amount of money. It need "absorb" little or no new money. The real estate market, on the other hand, is highly credit- and capital-intensive.

A second argument seems highly paradoxical. Yet, it's logical. There may well be excess money in the financial sphere precisely because the real economy is weak. John Maynard Keynes theorized that the *financial* circulation draws money from the *commercial-industrial* circulation. When the conduit into business is — so to say — clogged, money and credit instead flows into financial speculation. In that sense, repeated monetary stimulation fans the flames of financial speculation and nothing else.

SECULAR VERSUS CYCLICAL

The primary reason for the strong bullish sentiment on the U.S. dollar and the U.S. stock market over the past eight months has been the enduring view that the U.S. economy was on the road to recovery while Japan and German — the latter leading Europe — would be slowing markedly. Any reversal in the relative economic growth rates and in the monetary stance, it was enthusiastically believed, would power the dollar to DM 2.00 .

We, too, have always recognized the cyclical sensitivity of the dollar/DM rate. In the recent case, though,

we faulted the logic because it completely ignored the big differences in the stage and relative level of activity. Post-peak growth rates can't fairly be compared with post-recession growth rates.

The Japanese and German economies, to be sure, are slowing sharply, but they're doing so from levels of peak output after a long boom. On the other hand, the U.S. economy, after its negative growth rates will still be mired in recession even with 2-3% growth because that's little more than its potential growth rate. For the Fed to respond to such an anaemic recovery with higher interest rates would be suicidal. Rather, the U.S. needs more like 5-6% growth rates to come out of recession.

In any case, apparently it has yet to dawn on most experts that contemporary developments in the U.S. are not merely of a cyclical nature. Importantly, deeper, secular changes are at play as well. After all, what we're witnessing presently is the culmination of developments that have been in the making for almost a decade. As a consequence of the past overconsumption boom, the U.S. economy has ended up diminishing its growth potential to perhaps 2% (1% labour force growth and 1% productivity growth). Germany, by comparison, has raised its growth potential from 2.5% previously to at least 3%.

The U.S. economy, marked by its high consumption, low profitability and low growth, can no longer bear high interest rates. Seen on a secular trend basis, the economies of Japan and Germany are high-investment, high-profit and high-growth and can much better bear higher interest rates.

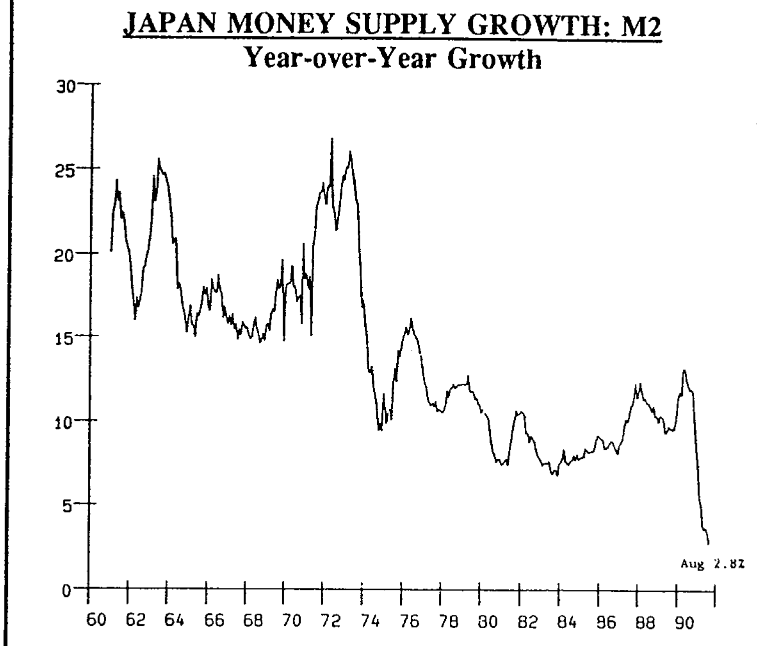
JAPAN'S CASE

Japan's economic growth record is clearly outstanding. Since 1987, industrial production has risen 26%, far outdistancing the growth rates of 19% in Germany and 8% in the United States. The critical factors in Japan presently, though, are the unprecedented monetary and financial excesses which led to the runaway inflation in stock prices and real estate — the now famous asset inflation. Apparently, it has become the Bank of Japan's (BOJ) explicit aim not only to halt this inflation but to also reverse it somewhat. Consequently, the central bank is in no hurry to ease despite the economy's rapid slowdown.

The most spectacular signs of the BOJ's tight credit grip are the steep plunges in credit and money growth. Within barely one year M2 growth has plunged from 12% to 2.4%, its lowest growth rate in 24 years. But Governor Mieno seems to take these dour developments in stride with the argument that the level of liquidity in the economy is high . . . in fact, too high. What counts he argues are not only the changes but also the levels.

No doubt, Japan's financial system is under tremendous strain after having gone to unprecedented excesses. It's far too early to assess the extent of the long-term fallout considering that Japanese banks and investors flooded the world with their lending and asset purchases between 1986 and 1990. This huge outflow of capital has now completely dried up. That makes U.S. markets vulnerable because they were the main recipients of Japanese capital exports in previous years.

Like their American counterparts, Japanese banks are now up against their BIS (Bank of International Settlements) capital ratios requirements. That forces them to retrench lending. Only in Japan's case, the capital decline was mainly triggered by the stock market collapse since unrealized gains on stocks holdings are partly counted as bank capital. The capital inadequacies in the United States, by contrast, as we already reviewed, stems mainly from the collapsing commercial real estate market even as stock prices have soared. In Japan, any new plunge in stock prices along with a looming real estate crisis could force the banks into an even sharper retreat and could play havoc with the economy both domestically and internationally.



Source: International Strategy and Investment, Sept. 30. 1991

Asset price deflation, bank capital inadequacies and collapsing money growth are the striking parallels between the two situations in Japan and the United States. Yet, there are crucially important differences that shouldn't be overlooked. The two economies differ like night and day in virtually every other respect; in their trade balances; in savings and investment ratios; in their budgetary positions; and, in debt and liquidity levels just to name a few. Japanese corporations generally still have extremely high liquidity ratios albeit unevenly distributed. Lately, though, a ferocious profit squeeze has set in.

Japan has large export and budget surpluses and therefore still has every available option in monetary and fiscal policy to counter any undesirable economic and financial developments. America with its large deficits has none.

GERMANY'S CASE

Next, to the other side of the globe. Germany's unification has attracted a litany of gloomy comments and reports predicting terrible consequences for Germany and its D-mark.

We dissent with that consensus view. No doubt, the German boom that had been propelled by unification has crested. A period of very slow growth or even temporary stagnation is destined to follow. Yet, it's outright nonsense to compare Germany's post-boom growth rates with the U.S. and U.K. rates of growth which have been falling for more than two years.

We've always been astonished at the prevailing logic which concludes that unification must have adverse implications for the German economy and the D-mark. In the first place, unification has allowed Germany to experience boom times at a time of international recession. And, it's been a buoying force keeping recession at bay in the rest of Europe. According to Bundesbank estimates, west German "exports" to east Germany over the year to mid 1991 corresponded to 4.5% of west German GNP of which 2% went into imports from other countries.

This big demand boost resulted partly from the currency union and partly from current transfer payments. Of these two stimulants to growth, the currency effect has probably dissipated and run its course. That alone implies a sharp decline in demand growth in the east. Simultaneously, tax hikes and tight money are slowing demand growth in the west Germany.

Few people seem to appreciate that the benefits of unification are enormous — a boon to demand, income, and employment — and extend far into the future. Instead, most of the public discussion — both

domestically and internationally — is captured solely by the question of the financial "costs."

From our perspective, the "costs" ultimately boil down to one transaction in macroeconomic terms: the huge reallocation of Germany's real resources from a giant export surplus to an internal transfer to the east. Resources that were once allocated to Germany's huge exports of capital equipment and other goods are now for a time being redirected inwardly. Unification would have a greater potential of being a problem if Germany didn't have these resources to start with.

The financial counterpart to the above resource transfer is provided by the German investor who has switched his purchases from foreign bonds to German bonds. Not including purchases by banks, to August of this year domestic investors had bought a net amount of bonds totalling DM 101 billion (DM 150 billion at an annual rate). That compares with DM 47 billion in 1989 and DM 128 billion for the whole of 1990. On the other hand, the purchase of foreign bonds are down sharply. Here we see that German unification doesn't need any capital imports. German bonds may be out of favour for the international speculator who's only interested in short-term capital gains. It's much better that the DM-bonds are being snapped up by the long-term-oriented German investor since it augurs well for the long-term strength of the D-mark and the bond market.

The first thing to realize is that the west German economy has accumulated unprecedented reserves of strength during the 1980s upswing. There were no financial excesses as there were in the U.S., Japan and many other countries. The financial structures consequently remain sound and strong. Germany experienced a healthy and balanced boom driven by exports, investment, and profits. As a share of national income, business profits rose from 15.5% in 1982 to 22.7% in 1990.

The German slowdown, not to forget, is intentional. It was the explicit purpose of the tax hikes and the Bundesbank's tight monetary policy to slow the economy. From the central bank's perspective it's "normalization" — not recession — given the mostly record-high capacity utilization. The consensus forecast calls for 2% GNP growth next year for west Germany and 12% in the east. Our expectation is that growth will be less in the west and higher in the east.

Two reasons underpin our different forecast: firstly, we think the Bundesbank will be forced to prolong its tight monetary policy — money growth remains at the high end of the range and trade unions are making insane wage demands; and secondly, the world economy stands to perform much weaker than expectations.

CONCLUSIONS

Worldwide, economic weakness is spreading and deepening. The consensus, led by the international organizations, still takes a 1992 recovery for granted. Yet, the projected growth rates of only 2-3% are hardly worthy of the name. Such growth rates are just in line with current capacity growth and therefore imply stagnating capacity utilization and rising unemployment.

We doubt that even this anaemic recovery is possible. A major negative is that many countries are now losing the strong support of the German and Japanese import booms which are now fading while the U.S. locomotive stalls. In Europe there is now more sluggishness than growth; Italy, Spain, France and particularly Britain are the weak spots. The Scandinavian countries are also very badly hit. Yet, the overall situation in Continental Europe still compares very favourably with that in the Anglo-Saxon countries.

Optimistic forecasts are blindly based on the typical pattern of the international postwar cycle. Focusing

on nothing but statistical trivialities, most economists are completely ignoring the serious financial obstructions in some of the major countries that are impeding growth over the longer run.

What's worse, there aren't signs of a sustainable recovery anywhere. Although the central banks have slashed interest rates in many countries, the money and credit data refuse to respond and continue to sink. On the contrary, the continued weakness warns of a progressive monetary weakening.

So far, discussions of 1992 economic performances have centred mainly on the question of relative growth with America leading the world recovery. In our view, rather than focusing on relative strengths, it's time to start pondering weaknesses and the relative vulnerabilities to a world recession. We plan to discuss this in coming letters.

Many observers, looking for the silver lining, exult that slowing debt growth is healthy. That is true, but slow debt growth after the point of overindebtedness is deadly.

As we stressed earlier, financial difficulties are not abating. Rather, they are worsening not only in the United States but elsewhere, too. According to experts, the destruction of U.S. property values still has years to run and threatens to continue ravaging the financial system in the process constraining credit and money growth.

The key point to see behind the low money growth figures in the U.S. is that the huge debt pyramid is crumbling. A financial accident such as a big bank failure or a stock market crash has a high probability and cannot be ruled out.

We sense that the euphoria is beginning to give way to an ominous, eerie scepticism. If things continue to worsen as we expect, outright alarm could quickly sweep the financial markets. That would cause the stock markets to finally capitulate to reality, and as such, fittingly sound the alarm to the approaching watershed.

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